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Japan buyouts: GPs see corporate reform as definitive source of deal flow

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Investors claim their pipelines are packed, despite the slow start to 2024. Take-privates should feature strongly – provided target companies respond positively to growing external pressures

Each of **The Carlyle Group's** five most recent Japan buyouts is a take-private, with four announced within the last 24 months. This period roughly coincides with the **Tokyo Stock Exchange's (TSE)** latest drive to clean up the markets and usher out inefficient and underperforming players.

There have been two significant actions. First, TSE's market segments were reorganised as prime, standard, and growth, with more stringent qualification criteria for each one. Second, companies trading below book value were instructed to disclose steps taken to remedy the situation. It offered further encouragement to activist investors descending on the TSE in record numbers.

The implication is that those unable to make the grade should consider delisting – and if there were any doubt, the Ministry of Economy, Trade, and Industry (METI) followed up last year with guidelines on how companies should respond to takeover proposals.

It already appears to be translating into more private equity activity, with AVCJ Research tracking at least 20 PE-backed take-privates since the start of 2023. There were an average of 10 per year for 2020 through 2022. Dealmakers expect more to come as pressure on companies ratchets up.

"Our deal flow used to be 100% corporate carve-out, but we see public-to-private deals picking up in our pipeline," said *Eiji* Yatagawa, a partner and head of Japan private equity at **KKR**.

"These transactions take time, maybe six months or more. METI's new M&A guidelines were only published last August, and corporate M&A and activist pressures based on that began to increase towards the end of last year, so we may see more deals in the next few quarters."

Despite all the hype, Japan endured the same slow start to the year as the rest of Asian private equity. Approximately USD 3.6bn has been deployed as of mid-June, of which USD 1.9bn went into buyout deals. In contrast, buyouts accounted for USD 39.6bn out of USD 45.9bn put to work in 2023. And the annual average for the past five years is USD 20bn out of USD 25.8bn.

It is tempting to exclude last year's bumper **Toshiba** take-private as an outlier, but the lack of large-cap transactions is part of the point. There were seven USD 1bn-plus deals last year. The top-ranking announced buyout for 2024 to date is a **Goldman Sachs**-led acquisition of property manager **Nihon Housing** at JPY 77bn (USD 503m). Sizes of many other Japan transactions are not disclosed.

There is a familiar sense among industry advisors that opportunities are being explored – across take-privates, carve-outs, and founder-succession deals – and not necessarily coming to fruition. However, like Yatagawa, they believe it could be about to change.

"A lot of deals are taking longer than expected or not reaching the valuations sellers are looking for, so they get pulled," said Gavin Raftery, a Tokyo-based partner in the finance and projects group at **Baker McKenzie**. There has been a bit of a turn in the last few months, with the market coming back on all dimensions. Take-private activity, especially, has picked up."

Internal intrigue

Explanations for the recent slowdown go beyond the bid-ask spread. Tsuyoshi Imai, a partner who advises on buyouts at **Ropes & Gray**, noted that the regulation is increasingly an obstacle. He cited the EU Foreign Subsidies Regulation, which took effect in 2023 and is part of the M&A disclosure process. Clearance is supposed to take two months, but it normally extends to 3-4 months.

Approvals related to antitrust and national security concerns can also be time-consuming. For example, **Bain Capital's** acquisition of **Proterial** – formerly Hitachi Metals – in late 2022 was held up for 18 months because the company owns patents relating to rare earth magnets used in electronic devices and China is the world's largest producer.

According to Paul Ford, a Tokyo-based partner at **KPMG**, regulation is a binary issue. Either the challenges are so acute that the bidder walks away, or approvals just get baked into the deal timeline by investors who recognise that large-cap transactions in Japan are scarce enough that they won't let impatience stand in the way of opportunity.

Ford regards poor preparation as a more significant threat to deal flow. Companies that haven't dealt with private equity before aren't necessarily ready for the intensity of a due diligence process. This exposes holes in data and may prompt questions regarding whether the seller has internal alignment.

"I've seen situations where certain stakeholder groups were very positive about a sale and others were opposed, and protracted infighting caused the deal to fail. Often, the factors that lead to a transaction opportunity – poor financial or organizational management – are the same factors that end up spiking the process," said Ford.

Dealmakers across the spectrum make versions of the same point. Koji Sasaki, managing partner of mid-cap manager **T Capital Partners**, meets at least twice a month with management teams contemplating privatisations. Few deals go anywhere, partly because management is motivated by a desire to avoid the stricter regulatory regime, not by the opportunity to make improvements.

The mismatch in motivations is also reflected in a reluctance to consider privatisation even though it is the only logical outcome and a failure to accept the need for capital efficiency that underpins the government's emphasis on corporate governance and the TSE reforms.

"Not all management teams are thinking seriously about it yet – they might prefer companies to stay listed. The CEO is always the key. If they are well aligned with us, the deal usually moves forward," said Takaomi Tomioka, a managing director and co-head of Japan at Carlyle.

Slow-burn story

The nature of these engagements means that deal sourcing can be a drawn-out affair, with an emphasis on building trust and establishing alignment – not only within the seller group but also with the prospective private equity buyer. Much the same applies to corporate carve-outs and founder-succession situations.

T Capital completed two investments last year, one carve-out and one sponsor-to-sponsor deal. Sasaki and others in the market expect to see more of the latter. First, some small to mid-size local GPs have accumulated extensive portfolios that they need to pare back. Second, a growing number of global and pan-regional private equity firms are actively looking for deals in Japan.

AVCJ Research has records of around 20 sponsor-to-sponsor exits in each of 2022 and 2023. Annual average deal count for the prior five years was less than 10. **Polaris Capital Group** announced two in December 2023 alone: **Sogo Medical** was sold to **CVC Capital Partners** for USD 1.1bn and **Hitowa Holdings** – which Polaris originally bought from CVC – went to **MBK Partners** for USD 631m.

Nevertheless, the more significant long-term opportunity is rooted in the transformation of corporate Japan. It is no coincidence that newly formed mid-cap GPs like **REVA Corporation** point to EBITDA growth – to be achieved through initiatives such as the digitalisation of family-owned businesses – as the foundation of their strategies.

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